

Words of wisdom for Woolley minded

Capital markets Jonathan Shapiro



More than a year since they arrived, tireless "Occupy Sydney" protesters are still holding fort outside the Reserve Bank of Australia's headquarters in Martin Place. Their cause is to protest against the size and influence of the financial sector.

Several kilometres away, at the inner-city campus of UTS in Ultimo, a cleaner but no less idealistic group is proving to be more active and effective.

The Centre for Capital Markets Dysfunctionality, the academic version of the Occupy movement, held its annual Sydney conference yesterday. Among its sponsors is the RBA, which has taken a keen interest in exploring the inefficiencies of the financial system.

The centre was created and is funded by Paul Woolley, a legendary figure in academic, regulatory and funds management circles. Alongside Jeremy Grantham, he established the hedge fund, GMO.

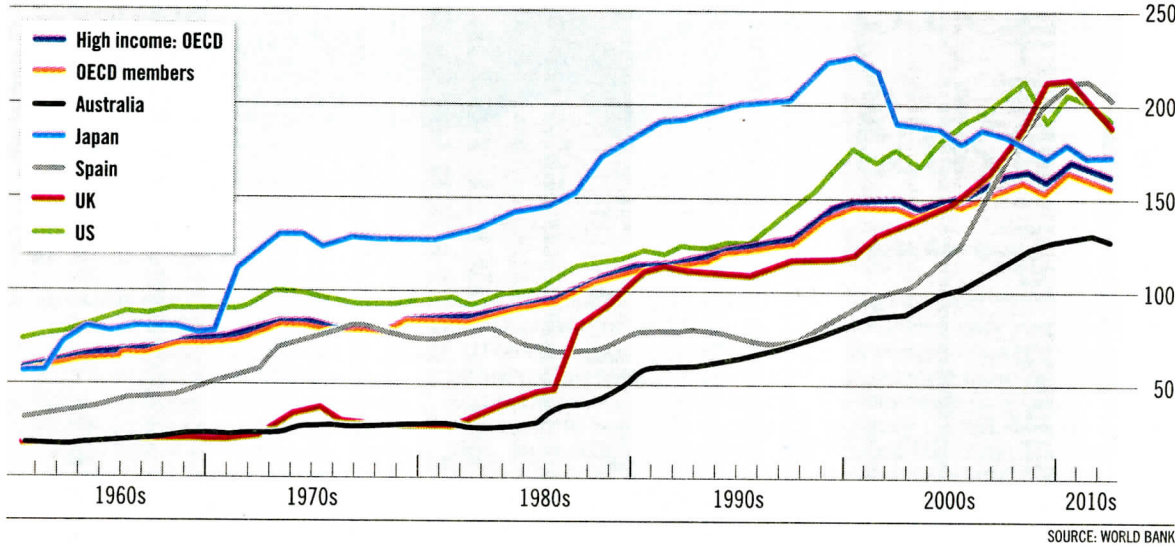
Woolley's mission, through the centre, is to rewrite financial theory that still regards market prices as rational. "[Investors] all know markets are deficient, but the whole instruction manual how to manage money is still based on a dud theory — the efficiency of markets," he told *The Australian Financial Review*.

The real-world evidence vindicates his thesis that people are rational, but markets aren't.

Banks and fund managers as

Lend to the end

Credit to GDP ratio (%)



SOURCE: WORLD BANK

rational agents will game the system to enrich themselves and, as they do, more regulators and pension funds are engaging with Woolley and the centre to understand their findings.

"There are a number of really big funds that realise we are on to something really serious," Woolley says.

The papers presented and discussions that took place yesterday — among central bankers, academics and Treasury officials — were more than academic.

Among local regulators to outline their thinking were the RBA's head of financial stability, Luci Ellis, and Treasury's Jim Murphy, who mused about the limitations of regulation in reining in the financial sector.

As debate resurfaced about the potential to stamp out a housing bubble before low interest rates allow it to form, Deniz Igan, from

the International Monetary Fund, presented research about how to deal with credit booms that warrant attention. Her conclusion was that in 175 instances the majority of credit booms were positive for the economies in which they occurred.

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Paul Woolley, the Centre for Capital Markets Dysfunctionality

A key insight from the paper for local regulators to mull over was that in 15 out of 25 instances where private sector credit to gross domestic product was in excess of 60 per cent, a credit boom was likely to be harmful to an economy. She would not be drawn on a definite

policy conclusion, but suggested there was a role for policy in managing excessive credit growth.

Amid calls for another Wallis inquiry into Australia's banking system, former APRA official John Trowbridge offered a timely update on how Australia's supervisory framework compared internationally and dismissed calls for an overhaul. He did, however, warn of a blind spot in the valley between the Australian Securities and Investments Commission and the Australian Prudential Regulation Authority.

"I call it a cliff between what APRA does and what ASIC does, and there's no such thing as APRA-lite," he said.

"You're either in or you are not, and because APRA regulation is seen as onerous anyone starting any financial enterprise will do their

best to avoid APRA regulation."

Regulating markets is essential but history has shown it to be far from foolproof in containing the irrationality of markets. Yale professor William Goetzmann's historical account of the stockmarket bubbles of the 1720s was both timely and timeless.

The bubble in the stock of the British trader South Sea Company is frequently cited, but Goetzmann's research showed that a range of companies in trading, real estate, banking and agriculture also issued stock that soared as eager investors piled in. One, called Wesley's Action, bought and sold shares and could lay claim to be the world's first hedge fund.

When the South Sea bubble burst, investor outrage reached fever pitch as losses mounted. The IPO market shut down and remained shut for more than a century — a fact that would send shivers down the spines of today's bankers.

However, the sector that ran the hardest, insurance, suffered a sharp correction but still rewarded investors. Goetzmann's message was that amid the insanity, the insurance sector was created, and it has helped to underwrite the risks of other industries ever since.

It's a reminder that moral outrage and judgment can mask the benefits of the capital markets.

"I'm the biggest advocate," says Woolley. "Capital markets aren't working as they should. Paradise is lost and I want paradise to be regained."

He's not trying to destroy markets, but save them from themselves.

"If it doesn't happen, we are getting to the final chapter of capitalism."

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